In Different Branches: Duality in the Profession

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Public Accounting, for years the almost invisible profession, is in the eye of an accelerating storm. Winds of change batter from all sides. The spectre of change and uncertainty hovers over what the Metcalf Reports call The Accounting Establishment. In 1977, the American Institute of Certified Public Accountants, goaded by internal and external pressures, effected structural changes to "enhance the effectiveness of the profession in the enviornment in which we practice." Flying before the winds of impending government regulation the Institute made three emergency moves. It created a new class of membership; it formed a new senior technical committee to deal with unaudited statements, and, it forwarded to the Financial Accounting Standards Board a committee report urging that private companies and public companies be reported under different sets of generally accepted accounting principles. The new class of membership permits accounting firms to join either or both the SEC practice section and the private companies practice section. These actions recognize that the profession is in substance two professions, one serving publicly listed companies and the other serving private or closely held companies. The Chairman of the FASB acknowledged the possibility of different GAAP for public and private companies. The acceptance of this duality may lead to different educational and ethical standards. Reporting standards are the first to be affected; the jury is still out as to whether measurement standards should be affected.

The reports of the Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs served as the catalyst for change. The March 1977 Journal of Accountancy contained the Staff Report of the Subcommittee. The final report is printed in the January 1978 Journal. These are referred to as the Metcalf Reports since Senator Metcalf was chairman of the Subcommittee. After public hearings on the staff report, the final report was issued with the Subcommittee stating that it had no immediate plans for new legislation but would hold new hearings in 1978 to determine how the profession was meeting the major concerns expressed in the report. The SEC is committed to report to Congress on July 1, 1978 as to the likelihood of the success of the professional efforts at self-regulation. Thus, the reprieve granted to the profession appears to be short.

Background.

The last decade brought reports of inequities perpetrated on small businesses and small accounting practitioners. The complaints centered on (1) the application of GAAP for all businesses, (2) the Code of Professional Ethics, (3) generally accepted auditing standards, and (4) the education of accountants. The Metcalf staff report highlighted the lack of an effective structure that would enable local practitioners to participate in the standards setting process.

A condition of significant duality has existed in the profession for many years, but has received little attention from professional organizations. The AICPA has apparently considered other national problems more pressing, and the state societies have been waiting for national leadership. However, among local practitioners there was much dissatisfaction which occasionally erupted in professional gatherings and literature. In later years the grounds for dissatisfaction began to work a real hardship on the local practitioners.

Figure 1 contains selected examples of duality in the accounting establishment. Note the recency of many of the developments.

The SEC.

From their inception in 1933 and 1934 the Securities and Exchange Acts recognized that all companies need not conform to the same reporting standards. The Acts only applied to those companies whose securities were traded on public exchanges. In 1974, John C. Burton, then chief accountant of the SEC, stated, "Public accounting is in reality two professions."[1] In his opinion the key to the difference between them is not size, quality, or credentials, but in the definition of the work "public". The distinction between the two rests on the beneficiaries of their services. In one the client is basically the beneficiary of the services, the accountants are responsible to their clients for their success or failure, attestation is not normally important, and, when performed is usually seen only by those who have a direct relationship with the clients, such as their bankers. The second profession, on the other hand, also

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contracts with the client, but it contracts to serve primarily the interests of those outside the client's firm.

Operationally, this distinction could probably best be based on whether the auditor's relationship is with companies whose shares are traded in the public market or not. The distinction between the public corporation and nonpublic entity does not divide the profession, it divides the clients. Many accounting firms, large and small, have both public and nonpublic clients.

The SEC also recognizes that differences exist between public companies. Securities Act Release No. 5427 contained an indication by the Commission that financial statements might be something other than uniform — that is, that there might be financial statements for the sophisticated investor and the professional analyst which would not be identical with financial statements for the so-called average investor. The Commission has also used the size of the entity as the determinant for some reporting requirements; segmented reporting and replacement cost information offer examples of differential reporting.

Auditing Standards Executive Committee (AudSEC).

During the 1970s the demand for the CPA's services and the expectations of users have grown at an ever-increasing rate. The Penn Central bankruptcy and other spectacular business failures have focused attention on the performance of the accounting profession. Court cases have zeroed in on auditing and reporting standards. The profession's response was an outpouring of rules, principles, and standards directed toward the auditing and presentation of financial data. Still, the majority of the rules and regulations have dealt with GAAP and auditing standards applicable to problems of large entities whose securities are traded on regulated exchanges.

Literature and standards dealing with unaudited financial statements have been scarce. In 1949 SAP No. 23, "Clarification of Accountant's Report when Opinion is Omitted" was issued. A lapse of eighteen years followed before the issuance of SAP No. 23, "Unaudited Financial Statements." Both statements were directed toward clearly identifying audited and unaudited statements but gave little guidance with respect to the service rendered.

In 1972 the AICPA appointed a task force to study the problems of unaudited statements. (The 1136 Tenants case triggered attention to the need for such a study.) Three years later the "Guide for Engagements of CPAs to Prepare Unaudited Financial Statements" was issued. The provisions of SAP Nos. 23 and 38 became Section 516 of SAS No. 1 "Codification of Auditing Standards and Procedures" issued in 1971. Changes since then are SAS Nos. 10 and 13, but they were issued to guide and establish procedures and reporting standards for the performance of a limited review whose purpose was designed primarily for public entities for which the auditor performed an audit of annual financial statements.

Accounting and Review Services Committee.

The Accounting and Review Services Committee was established in 1975 as a subcommittee of AudSEC. William A. Gregory, the chairman of that committee, writing in the February 1978 Journal of Accountancy states that the committee was established:

1. to reconsider all aspects of AICPA pronouncements applicable to the association of CPAs with unaudited financial statements, including participation in preparation of performance of review procedures for client prepared statements,
2. to consider appropriate types of services for such engagements, including different levels of assurance, and
3. to develop recommendations and guidance in this area of practice on a continuing basis.

In October 1977, the AICPA board of directors and council designated the committee a senior technical committee. As a senior committee it has the authority to issue its own pronouncements and establish standards concerning the types of accounting and review services that a CPA may render in connection with unaudited financial statements of an entity that is not required to file financial statements with a regulatory agency in connection with the public trading of its securities. Small businesses, usually the clients of local practitioners, will be the group most affected by the pronouncements of this committee.

After two years of research the committee concluded that

1. Auditing and accounting services are clearly distinguishable, both conceptually and pragmatically.
2. It is time that users of financial statements recognize that CPAs provide valuable services other than the audit function.
3. Accounting services in connection with unaudited financial statements are proper and useful professional activities for a CPA and deserve greater recognition.
4. The deluge of SASs has increased the cost of audits for many clients and has created a need to consider lower cost alternatives.
5. The profession needs specific guidance, primarily in the form of standards, in providing services of an accounting and review nature.

The committee perceives three levels of service that a CPA may perform with respect to financial statements: compilation, review, and audit. In the exposure draft of its first proposed statement it deals with compilation and review since audit is in the purview of AudSEC.

Compilation Service. The committee envisions that the compilation service enables the CPA to prepare financial statements from information furnished by the client. All of the requirements of GAAP may not necessarily be met. Such a service consists of the presentation of information in the form of financial statements and would require that the CPA obtain certain knowledge of the accounting practices and principles of the industry in which the client operates. The CPA would not be precluded from performing other services as writeup, adjusting and closing the books, or all services that many local practitioners perform with regularity. Obviously, such reports should be in appropriate form and free from obvious material errors. If the CPA becomes aware that information submitted in incorrect, additional data must be obtained. The accountant's report would contain an explicit statement of the services performed and a warning to users as to the responsibility assumed by the accountant.

Review. The objective in a review service is to achieve limited assurance that no material modifications are needed in order for the statements to be in compliance with GAAP or other regulatory standards. Such a review would differ from a compilation in that no assurance would be contemplated in a compilation service. The review for compliance would differ from an audit in that no basis for expressing an opinion would be provided; the procedures required for the two would be substantially different. The accountant's report would state

1. that a review has been performed in accordance with standards promulgated by the AICPA,
2. that a review is substantially less in scope than an audit and, accordingly, an opinion is not expressed on a review.
3. that the information included in the financial statements is the representation of the entity's management or owners, and
4. whether the CPA is aware of any material modifications that should be made to the financial statements.

Accounting Standards Executive Committee (AcSEC).

"CPAs and small businessmen have been wondering when, if ever, the Financial Accounting Standards Board will recognize that differences in accounting rules."[2] The Metcalf staff report observed that over one-half of this country's manufacturing, trade and retail sales are produced by businesses not listed on the New York or American stock exchanges. Yet, with few exceptions, the majority of the accounting principles are intended to meet the requirements of publicly owned enterprises and are irrelevant to the needs of smaller businesses. The copious additional accounting principles and reporting requirements mean that small business must bear excessive administrative and accounting costs to comply with the irrelevant rules.

"Little GAAP" Committee Report. In 1974 the accounting standards division of AICPA created a committee to study the application of GAAP for small and/or closely held entities. The committee was dubbed the "Little GAAP" committee. It was formed in response to widespread sentiment within the profession that the application of accounting principles uniformly to both large and small entities resulted in an unnecessary burden to both small business clients and the practitioners who serve them. In March 1975 a discussion paper was issued that contained basic questions concerning the differences in the application of GAAP: (1) Are there any differences? (2) If so, on what basis should different applications be determined? (3) What differences would be appropriate?, and (4) What impact would the differences have on the independent CPA?

After a comment period in August 1976, the "Little GAAP" committee issued its report in which it concluded that "there is strong support within the profession as a whole for reconsideration of present practices with respect to the application of generally accepted accounting principles to the financial statements of smaller and/or closely held businesses and with respect to standards for reports of CPAs on such statements."

The report was submitted by AcSEC to the FASB. Since AcSEC does not have the authority to modify GAAP the committee conclusions were presented in the form of recommendations.

Financial Accounting Standards Board (FASB).

The majority of the standards issued by the FASB have assumed that there are no material differences in the decision-making processes of those who use the financial statements of smaller or privately held enterprises and those who use the statements of publicly held companies. In a speech to the Indiana Association of CPAs in May 1977 Marshall Armstrong, then Chairman of the FASB, addressed some of the problems of the FASB's impact on small businesses.[3] He recognized that clients may resent having to pay for the assembly of information and review of data which is irrelevant to their needs. The "Little GAAP' report proposal that "the FASB should develop criteria for distinguishing between the disclosures which should be required in the statements of all entities, and those which merely provide additional or analytical data and thus might not be necessary" offered, in Mr. Armstrong's opinion, an intriguing approach which merits thorough consideration by those involved in the standard-setting process. Mr. Armstrong may have been prescient, or have had privileged knowledge. An Exposure Draft issued February 27 by the FASB proposes amendment of APB Opinion No. 15 and FASB Statement No. 14, to suspend reporting of earnings per share and segment information by nonpublic enterprises.

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AICPA.

At the annual meeting in September 1977, the AICPA's council approved a plan establishing a division of firm membership within the Institute. The firm memberships are divided into two sections: a SEC practice section and a private companies practice section. Firms are eligible for membership, on a voluntary basis, in either or both sections. Firms joining either section will be subject to stiff regulation. Creation of the firm membership responds to Congressional concerns about the profession's ability to regulate itself. Prior to this the only class of membership was for individuals. The membership requirements are shown on page ten.

The objectives of the SEC practice section are to achieve the following:

1. *Improve the quality of practice by CPA firms before the Securities and Exchange Commission through the establishment of practice requirements for member firms.*
2. *Establish and maintain an effective system of self-regulation of member firms by means of mandatory peer reviews, required maintenance of appropriate quality controls and the imposition of sanctions for failure to meet membership responsibilities.*
3. *Enhance the effectiveness of the section's regulatory system through the monitoring and evaluation activities of an independent oversight board composed of public members.*
4. *Provide a forum for development of technical information relating to SEC practice.*

REQUIREMENTS FOR MEMBERSHIP IN THE AICPA (SUMMARIZED)

Individual

Those who are in possession of valid CPA certificates, and who have passed an examination in accounting and other related subjects satisfactory to the Board of Directors.

Firm-SEC Practice Section.

Eligibility and Admission of Members. All CPA firms are eligible for membership even though they may not practice before the SEC. A written application, agreeing to abide by all of the requirements for membership, accompanied by requested firm information for the most recent fiscal year must be submitted to the section.

Requirements of members. Member firms shall be obligated to abide by the following:

1. Ensure that a majority of all firm members, resident in the U.S., eligible for AICPA membership belong to AICPA.
2. Adhere to quality control standards established by the AICPA.
3. Submit to peer reviews of the firm's accounting and audit practice every three years or at other times when requested.
4. Ensure that all firm professionals resident in the U.S. participate in at least 40 hours of continuing education annually.
5. Rotate partner in charge on audit assignments.
6. Require that a partner other than the audit partner in charge review all audit reports for an SEC registrant.
7. File designated information each fiscal year for the U.S. firm.
8. Maintain prescribed types and amounts of accountant's liability insurance.
9. Limit its scope of Management Advisory services (MAS).
10. Report annually on the fees from MAS, and the types of services rendered, to representatives of each SEC audit client.
11. Report on disagreements with management to representatives of each SEC audit client.
12. Pay dues and abide by regulations of the section.

Firm-Private Companies Practice Section.

Eligibility and Admission of Members. All CPA firms are eligible for membership in the section. A written application, agreeing to abide by all the requirements of membership, accompanied by requested non-financial information must be submitted to the section.

Requirements of Members. Member firms shall be obligated to abide by the following:

1. Ensure that a majority of firm members residing in the United States, and holding CPAs, are members of the Institute.
2. Adhere to quality control standards established by the AICPA.
3. Submit to peer reviews of the firm's accounting and audit practice every three years or at other times when requested.
4. Ensure that all firm professionals, resident in the U.S., participate in at least 40 hours of continuing education annually.
5. Maintain prescribed types and amounts of accountant's liability insurance.
6. Pay dues and abide by regulations of the section.

The objectives of the private companies practice section are to achieve the following:

1. *Improve the quality of services by CPA firms to private companies through the establishment of practice requirements for member firms.*
2. *Establish and maintain an effective system of self-regulation of member firms by means of mandatory peer reviews, required maintenance of appropriate quality controls and the imposition of sanctions for failure to meet membership responsibilities.*
3. *Provide a better means for member firms to make known their views on professional matters, including the establishment of technical standards.*

The reader will note that requirements numbers one and two of each class of membership are almost identical. The November 1977 Journal of Accountancy contains a description of the organizational structure of the two sections.

The means for self-regulation of the SEC practice section are: mandatory peer reviews, sanctions of firms, mandatory rotation of audit engagement partners, public reporting of certain firm information, and monitoring of the activities of the section by a public oversight board. The private companies practice section provides for greater recognition of the different needs of smaller businesses in standard setting and gives local and regional firms a greater voice within the AICPA.

Council's action in establishing a division for firms has been challenged by a small group of members. A suit has been filed in the New York State Supreme Court, by eighteen members from eleven states, which seeks an injunction against further implementation of the program until it is submitted to the membership for vote. (The CPA Letter, January 23, 1978.) The plaintiffs allege that the establishment of the division for firms exceeded the authority of council. Their complaint is grounded in the theory that new classes of membership have been created and that only the membership can approve new classes of membership.

Conclusions.

There is significant duality within the profession: The SEC distinguished between public and non-public entities; there are two senior technical committees of the AICPA, one setting auditing standards and another for unaudited statements; AICPA firm membership is divided into two sections — SEC practice and private companies practice; and, the FASB has already begun to distinguish between entities to which GAAP will apply. It is hoped that the Senate Committee on Governmental Affairs will conclude that the SEC practice section, with oversight from the SEC, satisfies the Metcalf report demand for an organization of accounting firms that will be capable of "establishing and enforcing minimum standards of auditor preformance and behavior which will satisfy the need for independent assurance that corporate financial reports fairly reflect corporate activities."

FOOTNOTES

[1]John C. Burton, "The Organization of the Public Accounting Profession," *The National Public Accountant,* November 1974.

[2]Charles Chazen and Benjamin Benson, "Fitting GAAP to Smaller Businesses," *The Journal of Accountancy,* February 1978.

[3]Marshall S. Armstrong, "The Impact of FASB Statements on Small Businesses," *The Journal of Accountancy,* August 1977.

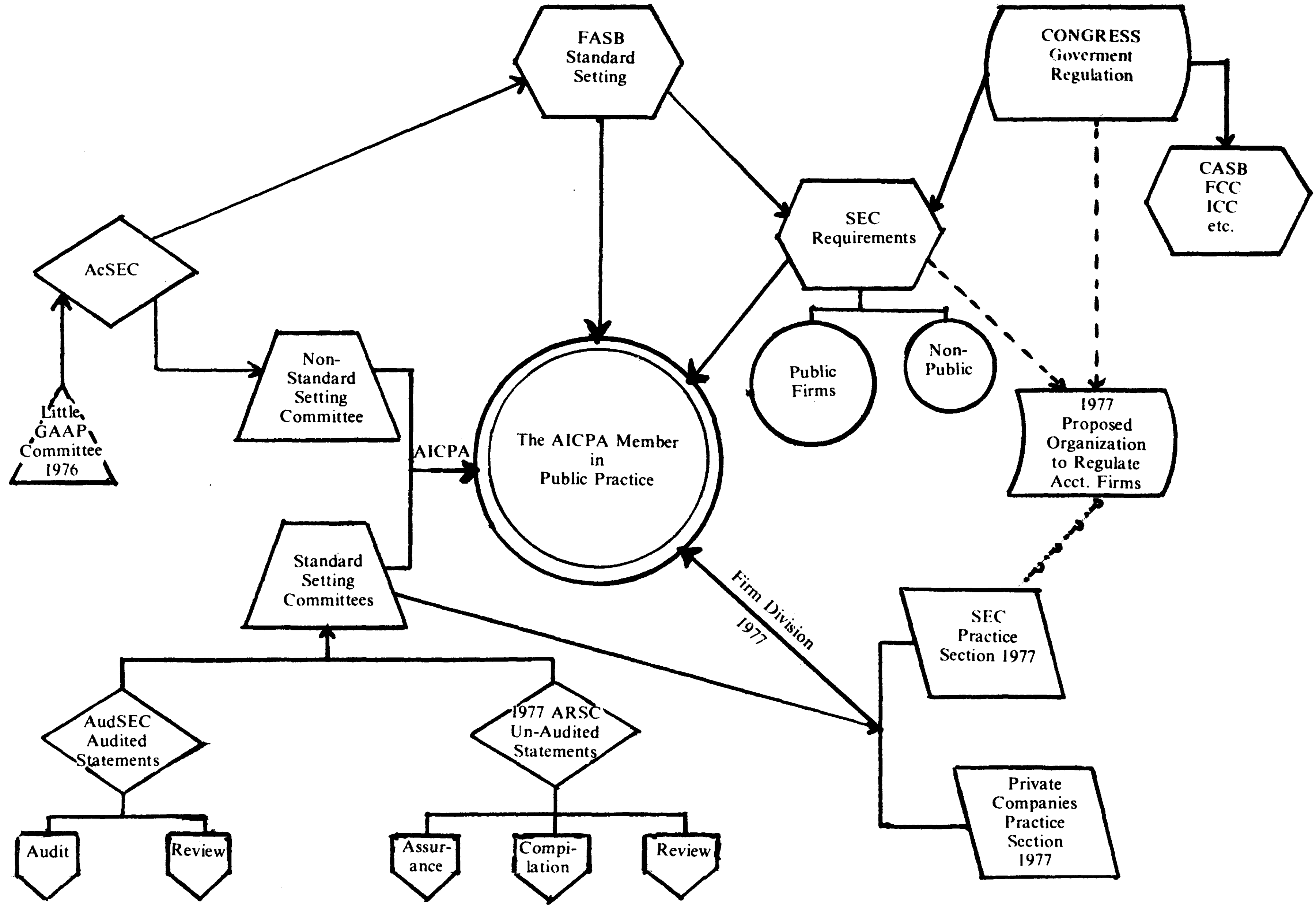

Figure 1
Examples of Duality in the Accounting Establishment